



**THE GUARANTEED STUDENT LOAN PROGRAMS'
OPERATING FUND AND FEDERAL FUND OF
THE NEW YORK STATE HIGHER EDUCATION
SERVICES CORPORATION**

Financial Statements

March 31, 2007 and 2006

(With Independent Auditors' Report Thereon)

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OPERATING FUND AND FEDERAL FUND OF
THE NEW YORK STATE HIGHER EDUCATION
SERVICES CORPORATION**

Financial Statements

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KPMG LLP
515 Broadway
Albany, NY 12207

Independent Auditors' Report

Board of Trustees
New York State Higher Education
Services Corporation:

We have audited the accompanying financial statements of the Operating Fund and Federal Fund of the Guaranteed Student Loan Programs of the New York State Higher Education Services Corporation (HESC), as of and for the years ended March 31, 2007 and 2006, which collectively comprise HESC's basic financial statements as listed in the table of contents. These financial statements are the responsibility of HESC's management. Our responsibility is to express opinions on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of HESC's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinions.

As discussed in note 1, the financial statements present only the Operating Fund and Federal Fund of the Guaranteed Student Loan Programs of HESC and do not purport to, and do not, present fairly the financial position of the New York State Higher Education Services Corporation as of March 31, 2007 and 2006 and its changes in financial position and its cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial positions of the Guaranteed Student Loan Programs' Operating Fund and Federal Fund of the New York State Higher Education Services Corporation as of March 31, 2007 and 2006, and the respective changes in financial positions, and cash flows thereof for the years then ended in conformity with U.S. generally accepted accounting principles.

In accordance with *Government Auditing Standards*, we have also issued a report dated, August, 27, 2007 on our consideration of the Operating Fund's and Federal Fund's internal control over financial reporting and on our tests of their compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

The accompanying management's discussion and analysis on pages 3 through 13 is not a required part of the basic financial statements but is supplementary information required by U.S. generally accepted accounting principles. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

KPMG LLP

August 27, 2007



Management's Discussion and Analysis

This section of the New York State Higher Education Services Corporation (HESC) Guaranteed Student Loan Programs' financial statements presents management's discussion and analysis of its operations and financial performance during the fiscal years ended March 31, 2007 and 2006. This analysis provides supplementary information on the operations and activities of HESC, and should be read in conjunction with the Operating and Federal Funds' financial statements, which follow this section.

Organization and Operations

HESC is an agency of New York State (NYS) created in 1974 under Chapter 942 of the Laws of 1974 and is responsible for the administration of New York State's student financial aid programs, including the Federal Family Education Loan Program (FFELP) and State loan guarantee programs.

FFELP was established by Congress and is administered by the U.S. Department of Education (ED) through HESC and other guaranty agencies. As a guaranty agency, HESC makes loans available through lending institutions to students attending colleges, universities, post-secondary educational, and vocational schools. FFELP allows HESC to guarantee repayment of principal and accrued interest to lenders for eligible student loans.

HESC'S VALUES

- **Our Employees**
● We are committed to teamwork, excellence, initiative, personal growth and responsibility.
- **Our Customers**
● We never take our customers for granted. We ask, we listen and we respond.
- **Our Products and Services**
● We are committed to high quality, dependability, and continuous improvements to meet the changing needs of our customers.

HESC has the responsibility of processing loans submitted for guarantee, issuing loan guarantees, providing collection assistance to lenders for delinquent loans, paying lender claims for loans in default, and collection activities on loans after purchase by HESC. In addition to FFELP, the Guaranteed Student Loan Programs (GSL) include the residual activity of the State guaranteed loan program in which no new loans have been guaranteed since 1984.

HESC has a Federal Student Loan Reserve Fund (Federal Fund) and an Operating Fund to account for FFELP activity. The Federal Fund assets, and earnings on those assets, are restricted in use and are considered property of ED. The Operating Fund is considered property of HESC, and its assets and earnings may be used generally for guarantee agency and other student financial aid related activities.

New York State Higher Education Services Corporation
Management's Discussion and Analysis (unaudited)
March 31, 2007 and 2006

2007 Financial Highlights-Operating Fund

- HESC guaranteed 57% of new student loans in New York State.
- Operating revenue increased \$21.7 million or 18.4%.
- Operating expenses increased \$12.3 million or 16.8%.
- The Operating Fund transferred \$5.4 million to the New York State Tuition Assistance Program (TAP) to subsidize grant expenditures and are committed to an additional \$8.0 million for the year ending March 31, 2007.
- The Operating Fund provided \$14.4 million for the cost of administering the New York State grants and scholarship program.
- The Operating Fund provided \$6.3 million to support the New York State Aid for Part Time Study program.
- The Operating Fund transferred \$32.2 million to the Federal Fund in order to meet the minimum reserve requirement.
- The Operating Fund deposited \$20.1 million into the Federal Fund for the mandatory federal default fee which was effective July 1, 2006.

2006 Financial Highlights-Operating Fund

- HESC guaranteed 56% of New York State's new student loans.
- Operating revenue increased \$4.0 million or 3.5%.
- Operating expenses increased \$3.0 million or 4.2%.
- The Operating Fund transferred \$46.6 million to the New York State Tuition Assistance Program (TAP) to subsidize grant expenditures and are committed to an additional \$4.7 million for the year ending March 31, 2006.
- The Operating Fund provided \$13.3 million for the cost of administration of New York State grants and scholarship program.
- The operating Fund provided \$5.6 million to support the New York State Aid for Part Time Study program.
- The Operating Fund transferred \$3.5 million to the Federal Fund in order to meet the minimum reserve requirement.

New York State Higher Education Services Corporation
Management's Discussion and Analysis (unaudited)
March 31, 2007 and 2006

Condensed Financial Information

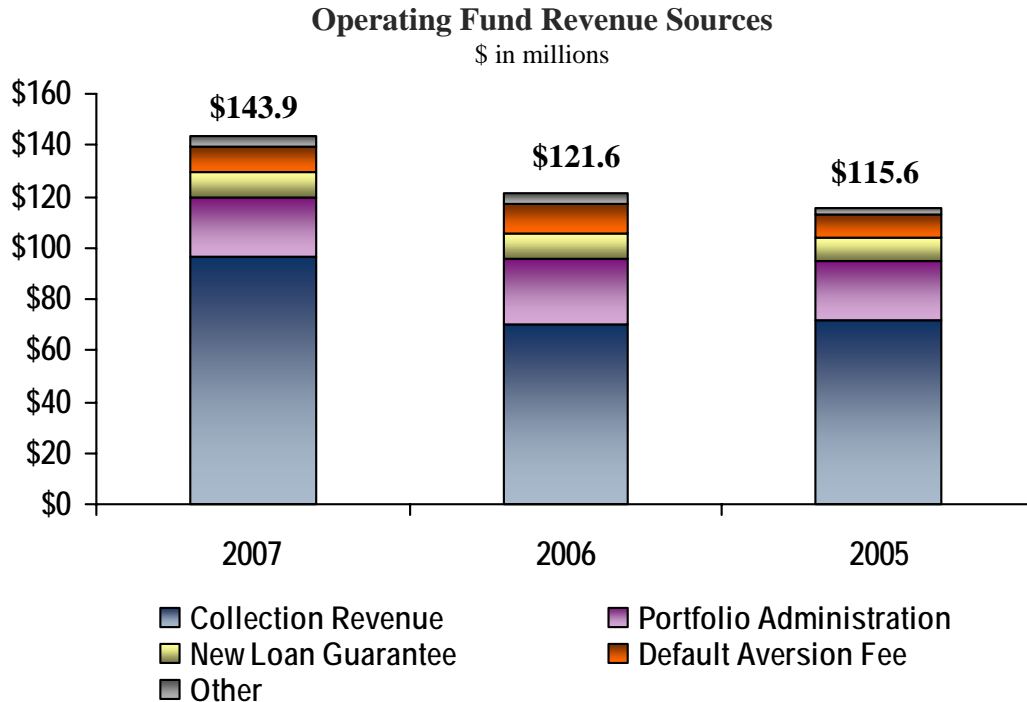
Amounts in thousands

	Operating Fund			Federal Fund		
	2007	2006	2005	2007	2006	2005
Current assets	\$ 44,828	68,109	96,023	82,609	64,074	82,696
Capital assets	128	228	291	—	—	—
Other noncurrent assets	—	—	—	6,029	7,077	7,435
Total assets	44,956	68,337	96,314	88,638	71,151	90,131
Current liabilities	29,884	31,238	32,735	6,013	19,890	—
Noncurrent liabilities	6,029	7,077	7,435	10,300	16,314	22,327
Total liabilities	35,913	38,315	40,170	16,313	36,204	22,327
Net assets:						
Invested in capital assets	128	228	291	—	—	—
Restricted	8,915	29,794	55,853	72,325	34,947	67,804
Total net assets	\$ 9,043	30,022	56,144	72,325	34,947	67,804

	Operating Fund			Federal Fund		
	2007	2006	2005	2007	2006	2005
Operating revenue:						
Default loan collections	\$ 96,084	70,110	71,646	201,479	125,366	113,697
Reimbursement on defaulted loans	—	—	—	421,198	371,442	312,147
Other	43,552	47,812	42,317	11	29	27
Nonoperating revenues	4,255	3,699	1,640	2,591	1,681	1,253
Total revenues	143,891	121,621	115,603	625,279	498,518	427,124
Operating expenses:						
Administrative	85,496	73,162	70,137	—	—	—
Default loan purchases	1	13	1	437,429	383,399	321,541
Collection payments to ED	—	—	—	191,835	120,857	111,091
Fee subsidies	—	—	—	10,919	30,611	15,409
Other	101	152	209	—	8	5
Nonoperating expenses	26,990	70,916	39,700	—	—	—
Total expenses	112,588	144,243	110,047	640,183	534,875	448,046
Transfers	(52,282)	(3,500)	—	52,282	3,500	—
Change in net assets	\$ (20,979)	(26,122)	5,556	37,378	(32,857)	(20,922)

New York State Higher Education Services Corporation
 Management's Discussion and Analysis (unaudited)
 March 31, 2007 and 2006

HESC Total Operating Fund Revenue... Continued Growth for Sixth Consecutive Year



Operating Fund Revenue Highlights for the fiscal year ending March 31,

2007

- Collection revenue represents 67% of total revenue.
- Portfolio administration revenue decreased by \$2.5 million as a result of a decline in the outstanding loan portfolio of 2.4% to \$23.65 billion.
- HESC guaranteed \$3.0 billion in new loans, an increase of \$.2 billion in loan volume, causing an increase in revenue of \$.7 million.
- Default aversion revenue decreased \$1.2 million to \$10.0 million as a result of a decrease in the number of default aversion assistance request processed during 2006-2007.

2006

- Collection revenue represents 58% of total revenue.
- Portfolio administration revenue increased by \$2.6 million as a result of outstanding loan portfolio growth of 10% to \$24.24 billion.
- HESC guaranteed \$2.7 billion in new loans, an increase of \$.2 billion in loan volume.
- Default aversion revenue rose to \$11.2 million as a result an increase in the number of default claims averted from the prior year.

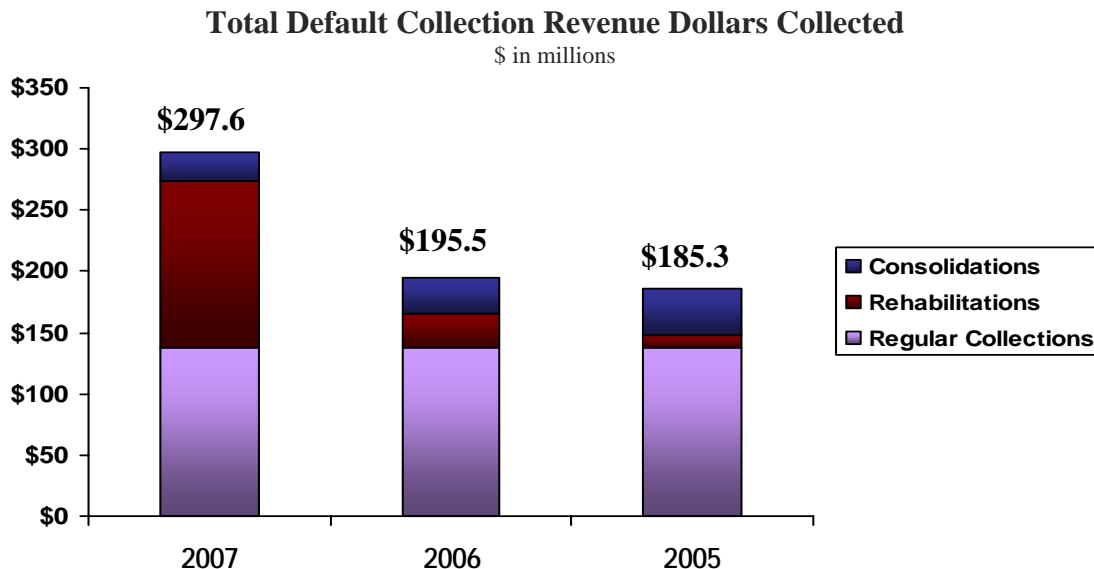
New York State Higher Education Services Corporation

Management's Discussion and Analysis (unaudited)

March 31, 2007 and 2006

Collection Revenue – Showing Shift in Collections Focus

As a FFEL guarantor, HESC retains a percentage determined by ED to collect defaulted student loans. Collection revenue shown below is the gross collection receipts by HESC in the respective years. HESC's primary source of revenue continues to be collection related revenue, accounting more than half of total HESC operating fund revenue for the past two fiscal years.



Fiscal Year Ending March 31, 2007

- Collections on rehabilitated loans increased 385% from \$28.1 million in 2006 to \$136.4 million in 2007. This increase is a result of the continued shift in collection focus to rehabilitations.
- Total regular collections remained constant from fiscal year 2006 to 2007. HESC is continually adding regular monthly paying borrowers and removing monthly paying borrowers through the loan rehabilitation process.
- Federal direct default consolidation revenue decreased during the fiscal year from \$29.5 million in 2006 to \$23.0 million in 2007. In addition, the agency retention on these consolidation loans declined from 18.5% to 10.0% effective October 1, 2006.

Fiscal Year Ending March 31, 2006

- Collections on rehabilitated loans increased 200% from \$9.4 million in 2005 to \$28.1 million in 2006. The increase is a result of the shift in collections focus from default consolidations to rehabilitations.
- Total regular collections remained constant from fiscal year 2005 to 2006. In house collections decreased and vendor collections increased as a result of vendor referrals.
- Federal direct default consolidation revenue decreased during the fiscal year from \$37.1 million in 2005 to \$29.5 million in 2006 as HESC placed more emphasis on rehabilitating borrowers.

New York State Higher Education Services Corporation
 Management's Discussion and Analysis (unaudited)
 March 31, 2007 and 2006

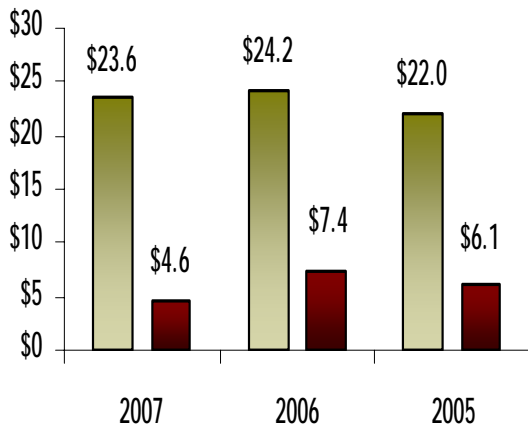
Operating Fund Administration Revenue on FFEL Guaranteed Loans

As a FFEL guarantor, HESC receives fee revenue for issuing new loan guarantees and for administering the outstanding guarantee loan portfolio. Administrative fee income decreased \$3.1 million or 7% for the fiscal year ending March 31, 2007 and increased \$5.4 million or 13% for fiscal year 2006.

Loan Guarantee Volume

Fiscal Year Ending March 31
 \$'s in billions

Loan Guarantee Volume
 Fiscal Year Ending March 31
 \$ in billions



■ Outstanding Loan Guarantee Portfolio ■ Annual Dollars Guaranteed

Loan Guarantee Volume

HESC guaranteed \$4.6 billion in student loans during the fiscal year ending March 31, 2007, a decrease of \$2.8 billion or 38% from 2006. New loan guarantees increased \$260 million or 10.0% to \$3.0 billion, and consolidation loans decreased \$3.1 billion to \$1.6 billion.

Guarantees for 2006 were \$7.4 billion, an increase of 21% or \$1.3 billion from 2005. New loan guarantees were \$2.7 billion, up \$.2 billion from 2005. Consolidation loan guarantees rose 34% during state fiscal year 2005-2006.

Loan Guarantee Revenue

HESC's outstanding portfolio balance decreased by \$.6 billion or 2.5% for the current fiscal year ending March 31, 2007, coupled with a change in the payment estimation process for federal fiscal year 2007, generated a decrease in account maintenance fee revenue of \$2.5 million. An increase in revenue of \$2.2 million was experienced in 2006 due to increased consolidation loans in the portfolio.

New loan guarantee revenue grew \$.7 million for the fiscal year ending March 31, 2007, due to a slight increase in new guarantees. An increase in new loan guarantees of 6% was experienced during fiscal year ending March 31, 2006 due to a small increase in new loan guarantees.

New York State Higher Education Services Corporation
 Management's Discussion and Analysis (unaudited)
 March 31, 2007 and 2006

Total HESC Operating Fund Expenses

March 31, 2007

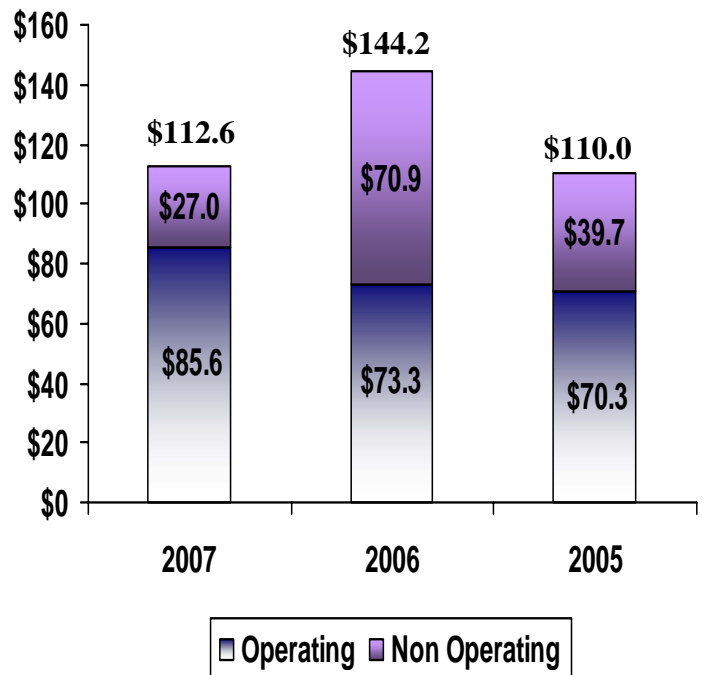
Operating Expenses

- Outsourced vendor collection service fees increased \$8.7 million or 66% as a result of increased vendor collections.
- Payroll and fringe benefits increased \$1.6 million due to an increase in full time equivalent employees.
- Payments to Office for Technology increased \$1.0 million from 2006 to 2007 as a result of rate and volume changes from 2006.
- Default Management Initiative Program operational expenses of \$1.0 million was paid in 2007, this expense was paid from restricted funds in the past.

Non Operating Expenses

- The operating fund contributed \$5.4 million to subsidize the TAP program and \$6.3 million for the Aid for Part Time Study program (APTS).
- The administrative costs of the grants and scholarship program totaling \$14.4 million was paid by the Operating Fund in 2007.
- The operating fund provided funds for the GEAR UP program's operational expenses administered by the state for the first time in 2007.

Fiscal Year Ended March 31
\$ in millions



March 31, 2006

Operating Expenses

- Outsourced vendor collection service fees increased \$1.8 million or 16% as a result of increased vendor collections.
- Personal service expense reflects a 4.5% increase in the rate paid for fringe benefits.
- Rent and utilities expense decreased \$1.0 million as a result of the consolidation of office space.
- Miscellaneous operating expenses include a payment for the new Overture project of \$1.3 million.

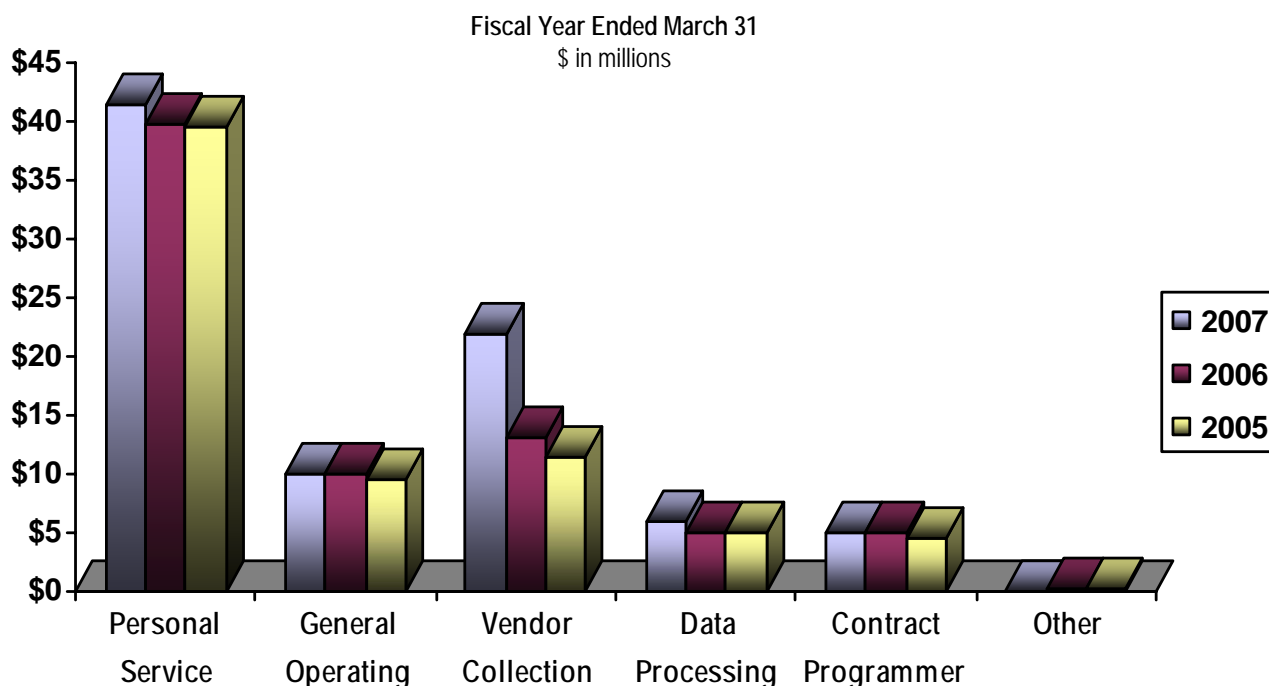
Non Operating Expenses

- The operating fund contributed for the first time \$51.3 million to subsidize the TAP program administered by NYS in March 2006. In addition, \$5.6 million was used for APTS.
- The operating fund continued to contribute to the cost of administration of the grants and scholarship program, \$13.3 million for the fiscal year ending March 31, 2006.

New York State Higher Education Services Corporation
 Management's Discussion and Analysis (unaudited)
 March 31, 2007 and 2006

Operating Fund Administrative Expenses

Operating fund administrative expenses increased from \$73.2 to \$85.5 million for the fiscal year ended March 31, 2007.



Personal Service

Personal service costs include salaries and fringe benefits. Fringe benefits for 2007 represent \$12.9 million or 45%. The increase in personal service and fringe benefits is a result of an increase in full time equivalent employees from 530 in 2006 to 579 in 2007. During fiscal year 2006 the FFEL program had a decrease of 17 full time equivalent employees from 2005.

General Operating

General operating expenses remained constant during the fiscal year ending March 31, 2007. An increase in rent expense was offset by the removal of the Financial Aid Training Grant expense in 2007. The slight increase in 2006 is a net of the increased cost for the Overture project offset by decreased rent expense. In addition, HESC incurred new costs for marketing and business analysts in 2006.

Vendor Collection

Vendor collection expense continues to increase in fiscal year 2006-2007 as a result of increased vendor collection activity. During the year ending March 31, 2007, vendor collection expense increased \$8.7 million dollars or 66%. For the period ended March 31, 2006, vendor collection expense increased \$1.8 million dollars or 16%.

Data Processing

Data processing costs increased approximately \$1.0 million during fiscal year ended March 31, 2007. The change in expense from 2005 to 2006 was \$100,000.

Contract Programmers

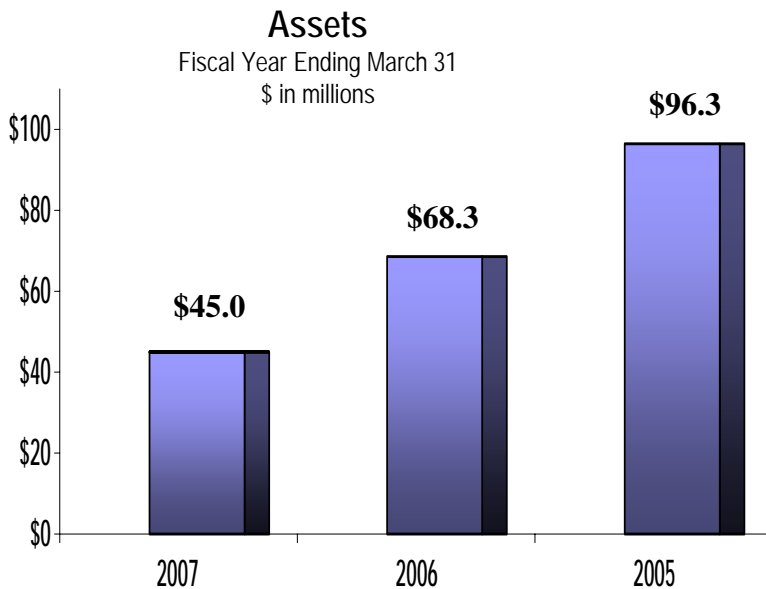
Contract programmer expenses have remained constant over the past two years. In fiscal year 2007 the cost increased approximately \$60,000. The cost for 2006 had increased \$500,000 from 2005.

New York State Higher Education Services Corporation

Management's Discussion and Analysis (unaudited)

March 31, 2007 and 2006

Assets & Liabilities- Operating Fund

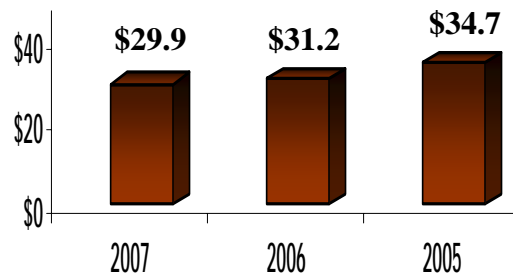


- Total operating assets are primarily current assets, consisting of cash and cash equivalents, receivables due from the U.S. Department of Education and the Federal Fund.
- Current assets decreased \$23.3 million or 34% as a result of transfers to the Federal Fund of \$52.3 and the transfer to NYS for TAP and APTS payments.
- Administrative fees receivable increased \$6.6 million in 2007 as a result of the account maintenance fee payment for March 2007 paid in June.
- The operating fund had a negative cash flow of \$15.6 million for the fiscal year ending March 31, 2007.
- Interfund balances for 2007 resulted in a net amount due to the Federal Fund and a change of \$18.1 million from the 2006 receivable balance.

Liabilities

Fiscal Year Ending March 31
\$ in millions

- Accrued liabilities represented 56% of total liabilities for the year ended March 31, 2007 and 63% of total liabilities in 2006.
- Accounts payable decreased \$4.7 million in fiscal year 2007 primarily due to \$4.7 million of the NYS budget appropriation for TAP accrued in 2006.
- Interfund balances for 2007 represents a \$4.3 million liability, partially offsetting the TAP liability for 2006.



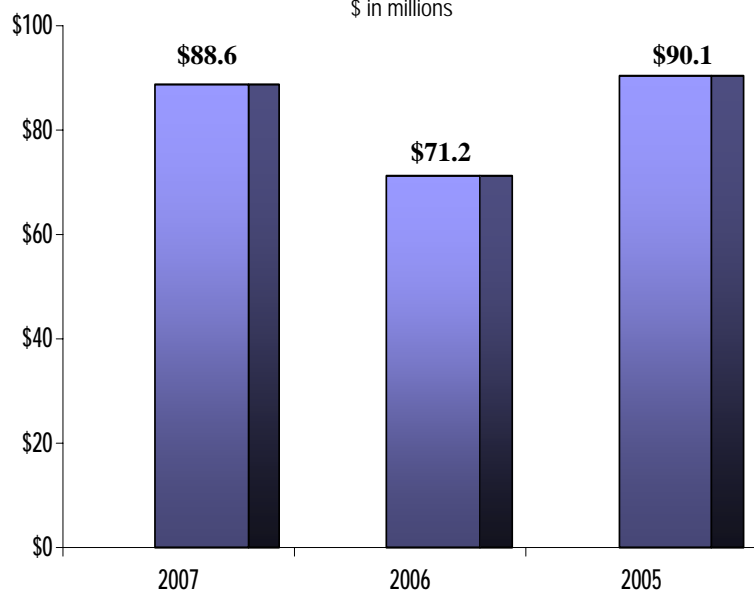
New York State Higher Education Services Corporation
 Management's Discussion and Analysis (unaudited)
 March 31, 2007 and 2006

The Federal Student Loan Reserve Fund (Federal Fund)

The Federal Fund assets are owned by the U.S. Department of Education (ED) and have restricted use, primarily to reimburse lender claims for defaulted student loans.

Federal Fund Assets

Fiscal Year Ending March 31
 \$ in millions

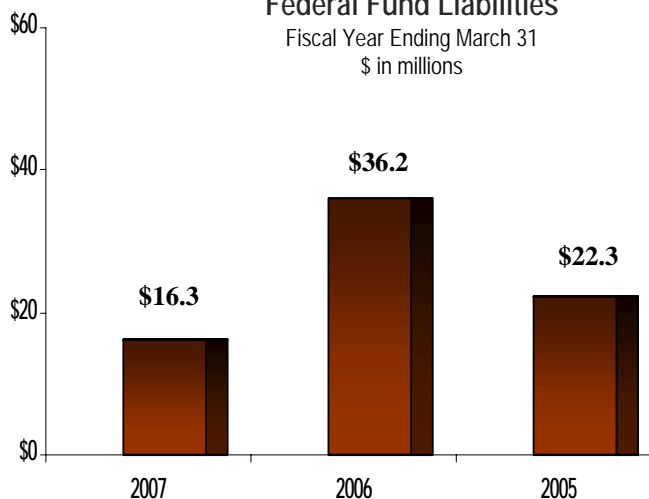


- The Federal Fund's current assets increased in fiscal year 2007 due to the infusion of funds from the Operating Fund in September 30, 2006 of \$32.2 million to meet the minimum reserve requirement. The decrease in the prior year is a result of total expenses exceeding total revenue in fiscal year 2006.
- The implementation of the required Federal Default Fee payment to the Federal Fund effective July 1, 2006 increased cash in the current fiscal year by \$20 million.
- The reinsurance receivable decreased in 2007 as a result of monthly reinsurance billings being filed twice a month.

- The Federal Fund liabilities for the fiscal years ended 2007 and 2006 include \$6 million and \$12 million respectively, representing reserve recall amounts. The reserve recall amounts was transferred to ED in two equal installments of \$6 million in September of 2006 and then in September 2007.
- Current liabilities in 2006 include \$10.0 million for account maintenance fee earned in fiscal year 2006 which was transferred from the Federal Fund in May 2006.


Federal Fund Liabilities


Fiscal Year Ending March 31
 \$ in millions





New York State Higher Education Services Corporation
Management's Discussion and Analysis (unaudited)
March 31, 2007 and 2006


Significant Known Facts, Decisions, or Conditions

-  The Governor's 2007-2008 New York State budget calls for HESC to fund \$8 million of TAP expenditures from the Agency Operating Fund .

-  The Operating Fund will continue to support the operational expenses of the Grants and Scholarship program in the amount of approximately \$14.4 million.

-  HESC's fringe benefit rate for 2007-2008 has increased 2% to 48.9%.

-  HESC reached an agreement with the Federal Department of Education on an outstanding payment regarding HESC's rehabilitation revenue retention from 1996 – 2004. The agreement will allow HESC to recapture \$16.9 million in Agency Operating Fund revenue when revenue in the Federal Fund exceeds the required minimum reserve level.

-  The Operating Fund will continue to pay the federal default fee on behalf of the students through June 30, 2008, at a cost of approximately \$28 million in state fiscal year 2007-2008.

Contacting Financial Management

This financial report is designed to provide our customers, business partners and creditors with a general overview of the Guaranteed Student Loan Programs' finances. For further detail information regarding the FFEL Program, you may also review our annual report on the web at [**www.hesc.com**](http://www.hesc.com).

Questions about this report can be directed to HESC's Chief Financial Officer, Warren E. Wallin at (518) 473-1200 or [**wwallin@hesc.com**](mailto:wwallin@hesc.com).

**THE GUARANTEED STUDENT LOAN PROGRAMS'
OPERATING FUND AND FEDERAL FUND OF
THE NEW YORK STATE HIGHER EDUCATION
SERVICES CORPORATION**

Statements of Net Assets

March 31, 2007 and 2006

Assets	2007		2006	
	Operating fund	Federal fund	Operating fund	Federal fund
Current assets:				
Cash and cash equivalents (note 4)	\$ 33,553,943	55,349,961	49,180,725	31,992,729
Receivables due from U.S. Department of Education				
Administrative fees (note 5)	10,720,182	—	4,115,374	—
Reinsurance	—	22,985,354	—	32,077,284
EFT fees receivable from lenders	276,340	—	347,079	—
Interfund balances (note 7)	—	4,255,392	13,877,162	—
Due from other sources (note 8)	63,398	—	229,930	—
Prepaid expenses and other assets	207,625	—	355,251	—
Accrued interest	6,460	18,714	3,282	3,918
Total current assets	44,827,948	82,609,421	68,108,803	64,073,931
Noncurrent assets:				
Interfund Default Aversion Fee Allowance (note 5)	—	6,028,872	—	7,077,052
Capital assets, net (note 12)	127,642	—	228,171	—
Total noncurrent assets	127,642	6,028,872	228,171	7,077,052
Total assets	\$ 44,955,590	88,638,293	68,336,974	71,150,983
Liabilities and Net Assets				
Current liabilities:				
Accounts payable and accrued liabilities	\$ 19,991,934	—	20,034,018	—
Due to New York State (note 9)	—	—	4,700,000	—
Interfund balances (note 7)	4,255,392	—	—	13,877,162
Amounts payable to lenders through EFT	5,636,944	—	6,455,465	—
Federal reserve return (note 13)	—	6,013,293	—	6,013,293
Due to other sources	—	—	48,601	—
Total current liabilities	29,884,270	6,013,293	31,238,084	19,890,455
Noncurrent liabilities:				
Due to U.S. Department of Education (note 13):				
Advance from U.S. Department of Education	—	10,300,348	—	10,300,348
Federal reserve return	—	—	—	6,013,293
Interfund Default Aversion Fee Allowance (note 5)	6,028,872	—	7,077,052	—
Total noncurrent liabilities	6,028,872	10,300,348	7,077,052	16,313,641
Total liabilities	35,913,142	16,313,641	38,315,136	36,204,096
Net assets:				
Invested in capital assets	127,642	—	228,171	—
Restricted – property of U.S. Department of Education	—	72,324,652	—	34,946,887
Restricted – for Default Management Initiatives	—	—	130,348	—
Restricted – for student aid related activities	8,914,806	—	29,663,319	—
Total net assets	\$ 9,042,448	72,324,652	30,021,838	34,946,887

See accompanying notes to financial statements.

**THE GUARANTEED STUDENT LOAN PROGRAMS'
OPERATING FUND AND FEDERAL FUND OF
THE NEW YORK STATE HIGHER EDUCATION
SERVICES CORPORATION**

Statements of Revenue, Expenses, and Changes in Net Assets
Years ended March 31, 2007 and 2006

	2007		2006	
	Operating fund	Federal fund	Operating fund	Federal fund
Operating revenues:				
Defaulted loan collections (note 6)	\$ 96,084,420	201,479,362	70,109,937	125,365,579
Administrative and program fee income (note 5)	43,552,444	—	46,627,686	—
Reimbursement on purchases of default loans from lenders (note 14)	—	421,197,722	—	371,442,433
Other revenue	1,172,105	11,212	1,183,788	29,378
Total operating revenues	<u>140,808,969</u>	<u>622,688,296</u>	<u>117,921,411</u>	<u>496,837,390</u>
Operating expenses:				
Salaries and employee benefits	41,352,527	—	39,729,719	—
General and administrative	15,126,587	—	15,169,934	—
Collections	21,928,522	—	13,204,044	—
NYS Office for Technology equipment usage charges	6,048,626	—	5,057,261	—
D.M.I. program expenses	1,040,255	—	—	—
Default aversion fee subsidy	—	9,967,752	—	11,207,767
Account maintenance fee subsidy	—	951,422	—	19,403,671
Purchases of default loans from lenders (note 14)	—	437,429,395	—	383,399,219
Defaulted loan collections paid to U.S. Department of Education	—	191,834,670	—	120,856,865
Depreciation	100,529	—	152,227	—
Other expense	—	250	—	7,550
Purchases of defaulted State loans from lenders	1,490	—	13,282	—
Total operating expenses	<u>85,598,536</u>	<u>640,183,489</u>	<u>73,326,467</u>	<u>534,875,072</u>
Operating income (loss)	<u>55,210,433</u>	<u>(17,495,193)</u>	<u>44,594,944</u>	<u>(38,037,682)</u>
Nonoperating revenues (expenses):				
Interest income	3,082,376	2,590,814	3,699,433	1,680,791
Financial aid training grant (note 10)	—	—	(728,574)	—
Gear Up operational expenses	(931,888)	—	—	—
New York State initiatives (note 9)	(26,058,167)	—	(70,187,579)	—
Total nonoperating (expenses) revenues	<u>(23,907,679)</u>	<u>2,590,814</u>	<u>(67,216,720)</u>	<u>1,680,791</u>
Transfer to Federal Fund (note 11)	(32,183,883)	32,183,883	(3,500,000)	3,500,000
Transfer of Federal Default Fee (note 15)	(20,098,261)	20,098,261	—	—
Increase (decrease) in net assets	(20,979,390)	37,377,765	(26,121,776)	(32,856,891)
Net assets, beginning	30,021,838	34,946,887	56,143,614	67,803,778
Net assets, ending	<u>\$ 9,042,448</u>	<u>72,324,652</u>	<u>30,021,838</u>	<u>34,946,887</u>

See accompanying notes to financial statements.

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Statements of Cash Flows

Years ended March 31, 2007 and 2006

	2007		2006	
	Operating fund	Federal fund	Operating fund	Federal fund
Cash flows from operating activities:				
Receipts from:				
Collections	\$ 96,795,131	200,837,916	55,183,554	139,479,866
Administrative fees	47,842,239	—	41,446,298	—
Other sources	1,409,376	11,212	1,181,324	29,378
Reimbursement on purchases of default loan purchases	—	430,174,341	—	359,063,245
Payments for:				
Salaries and employee benefits	(40,786,330)	—	(38,794,926)	—
Administrative fees	—	(21,813,777)	—	(19,841,498)
Purchases of default loans from lenders	(1,490)	(437,429,395)	—	(383,399,219)
Collections paid to U.S. Department of Education	—	(191,719,360)	—	(120,860,757)
General, administrative and other expenses	(45,011,314)	(249)	(30,202,971)	(7,550)
Net cash provided by (used in) operating activities	<u>60,247,612</u>	<u>(19,939,312)</u>	<u>28,813,279</u>	<u>(25,536,535)</u>
Cash flows from noncapital financing activities:				
Payments to NYS – other student aid activities	(32,219,773)	—	(64,351,416)	—
Transfer to Federal Fund	(46,733,819)	46,733,819	(3,500,000)	3,500,000
Payment to DOE for Federal Recall	—	(6,013,293)	—	—
Payments to schools for financial aid training grant	—	—	(728,574)	—
Net cash (used in) provided by noncapital financing activities	<u>(78,953,592)</u>	<u>40,720,526</u>	<u>(68,579,990)</u>	<u>3,500,000</u>
Cash flows from capital and related financing activities:				
Purchases of capital assets	—	—	(89,616)	—
Net cash used in capital and related financing activities	<u>—</u>	<u>—</u>	<u>(89,616)</u>	<u>—</u>
Cash flows from investing activities:				
Interest received	3,079,198	2,576,018	3,699,397	1,683,663
Net cash provided by investing activities	<u>3,079,198</u>	<u>2,576,018</u>	<u>3,699,397</u>	<u>1,683,663</u>
(Decrease) increase in cash and cash equivalents	(15,626,782)	23,357,232	(36,156,930)	(20,352,872)
Cash and cash equivalents, beginning	49,180,725	31,992,729	85,337,655	52,345,601
Cash and cash equivalents, ending	<u>\$ 33,553,943</u>	<u>55,349,961</u>	<u>49,180,725</u>	<u>31,992,729</u>

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Years ended March 31, 2007 and 2006

	2007		2006	
	Operating fund	Federal fund	Operating fund	Federal fund
Operating income (loss)	\$ 55,210,433	(17,495,193)	44,594,944	(38,037,682)
Adjustments to reconcile operating income (loss) to net cash provided by (used in) operating activities:				
Depreciation	\$ 100,529	—	152,227	—
Change in assets and liabilities:				
Receivables	(6,604,808)	9,091,930	5,588,553	(12,383,080)
Other assets	336,296	—	45,437	—
Interfund balances	12,584,229	(12,584,229)	(24,526,443)	24,526,443
Accounts payable and accrued liabilities	487,634	—	386,344	—
Other liabilities	(818,521)	—	2,930,001	—
Allowance for default aversion refunds	(1,048,180)	1,048,180	(357,784)	357,784
Total adjustments	5,037,179	(2,444,119)	(15,781,665)	12,501,147
Net cash provided by (used in) operating activities	\$ 60,247,612	(19,939,312)	28,813,279	(25,536,535)

See accompanying notes to financial statements.

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(1) Organization and Operations

New York State Higher Education Services Corporation (HESC) is an agency of New York State (NYS) created in 1974 under Chapter 942 of the Laws of 1974 and is responsible for the administration of New York State's student financial aid programs, including the Federal Family Education Loan Program (FFELP) and State loan guarantee programs.

FFELP was established by Congress and is administered by the U.S. Department of Education (ED) through HESC and other guarantee agencies. As a guarantee agency, HESC makes loans available through lending institutions to students attending colleges, universities, postsecondary educational, and vocational schools. FFELP allows HESC to guarantee repayment of principal and accrued interest to lenders for eligible student loans. HESC has the responsibility of processing loans submitted for guarantee, issuing loan guarantees, providing collection assistance to lenders for delinquent loans, paying lender claims for loans in default, and performing certain collection activities on loans after purchase by HESC. In addition to FFELP, the Guaranteed Student Loan Programs (GSL) include the residual activity of the State guaranteed loan program in which no new loans have been guaranteed since 1984.

The accompanying financial statements only reflect the Operating Fund and Federal Fund of the Guaranteed Student Loan Programs of HESC. The Higher Education Amendments of 1998 (1998 Amendments) were enacted on October 6, 1998 and changed the manner in which FFELP is administered. Under the Amendments, HESC established a Federal Student Loan Reserve Fund (Federal Fund) and an Operating Fund as required to account for FFELP activity. The Federal Fund assets, and earnings on those assets, are restricted in use and are considered property of the U.S. Department of Education. The Operating Fund is considered property of HESC and its assets and earnings may be used generally for all guarantee agency and other student financial aid related activities.

HESC also administers the Tuition Assistance Program, State Scholarship Programs, Federal Gear Up Program and Robert L. Byrd Federal Scholarship Program under which students apply for payments to attend particular educational institutions based on family income and/or academic achievement. These programs are not included in the accompanying financial statements.

(2) Significant Accounting Policies

Basis of Accounting

The Guaranteed Student Loan Programs' Operating Fund and Federal Fund follow fund accounting under U.S. generally accepted accounting principles (GAAP) in which resources are classified for accounting and reporting purposes into funds established according to their purpose.

The Guaranteed Student Loan Programs' funds consist of the Federal Fund and the Operating Fund. The Federal Fund finances FFELP insurance activities, while the Operating Fund accounts for substantially all FFELP operational costs as well as financial aid awareness and related outreach activities. The two funds together constitute the Guaranteed Student Loan Programs and are accounted for as business type activities using the flow of economic resources measurement focus and the accrual basis of accounting. Revenues

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are recognized when earned and expenses are recognized when the liability is incurred regardless of the timing of the related cash flow.

In accordance with Government Accounting Standards Board (GASB) Statement Number 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities that use Proprietary Fund Accounting*, the Operating and Federal Fund have elected to apply all applicable GASB pronouncements as well as Financial Accounting Standards Board (FASB) pronouncements and Accounting Principles Board (APB) opinions issued on or before November 30, 1989, unless those pronouncements conflict with or contradict GASB pronouncements. These Funds have also elected not to apply accounting standards issued after November 30, 1989 by FASB and APB.

Cash and Cash Equivalents

Cash and cash equivalents consisting of short-term repurchase agreements are carried at fair value. Investment income represents interest on deposits and gains and losses.

Operating Revenues and Expenses

Operating revenues and expenses result generally from activities associated with FFELP, including collection on defaulted loans, default prevention, and default loan purchase activities. All revenues and expenses not derived from the administration of the FFEL program are reported as nonoperating revenues and expenses.

Use of Estimates

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Management estimates include useful lives in depreciating capital assets, and anticipated future default aversion fee refunds. Actual results could differ from those estimates.

(3) Guaranteed Loans Outstanding and Respective Unpaid Balances

As of March 31, 2007 and 2006, the Federal Fund was the guarantor of loans outstanding with original principal amounts of approximately \$23,646,000,000 and \$24,243,000,000, respectively, made to students by participating lending institutions. Substantially all of that amount is guaranteed by the U.S. Department of Education, with an amount representing less than 1% guaranteed by the State of New York. At March 31, 2007 and 2006, the unpaid balances were approximately \$21,597,000,000 and \$22,149,000,000, respectively.

HESC's management anticipates that a certain portion of the loans outstanding as of March 31, 2007 and 2006 will go into default status, requiring the Federal Fund to purchase loans from lenders. Because the majority of these loans are Federally guaranteed, the Federal Fund will be reimbursed by the U.S. Department of Education.

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(4) Cash and Cash Equivalents

HESC's investment policy requires the Corporation to invest in low risk investments that are fully collateralized by the dealer. Cash equivalents are short-term investments with remaining maturities of three months or less when purchased and are generally short-term United States Treasury Bills and collateralized repurchase agreements. Cash equivalents are recorded at cost plus accrued interest, which approximates the fair value at March 31, 2007 and 2006. Federal Fund amounts and reserve recall amounts are restricted in use and are property of the U.S. Department of Education. HESC actively manages the investments of its cash balances to minimize its uninvested funds. Excess cash balances are generally invested in short-term repurchase agreements until such time that HESC anticipates the funds will be required for operational needs. Cash balances in an administrative account in the Operating Fund are invested in the New York State Comptroller's short-term investment pool. These cash balances are available to HESC upon demand.

Custodial credit risk for cash and cash equivalents is the risk that in the event of the failure of the counterparty to a transaction, HESC will not be able to recover the value of cash and cash equivalents that are in the possession of an outside party. In order to manage this risk, HESC requires collateral consisting of Federal government obligations or agency instruments guaranteed by the Federal government pursuant to its investments in repurchase agreements and delivery to its Trustee (agent) of all securities purchased and collateral for repurchase agreements, regardless of the seller institution. Additionally, HESC's investment policy limits the amount of funds which may be invested at any given dealer to \$75 million. Additionally, to manage custodial credit risk on deposits, HESC requires that its depository banks pledge collateral based on available bank balances.

Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of a cash equivalent. HESC's policy for managing this risk is to hold cash equivalents to maturity, at which time the fair value of the investment is equal to its stated maturity value.

Included in Operating Fund bank balances are \$5,636,944 for 2007 and \$6,455,465 for 2006, which were deposited by lenders, to be forwarded to schools generally within three business days under an electronic funds transfer program (EFT). The offsetting liability is shown as amounts due to lenders, which are held by HESC for future disbursement.

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Cash and cash equivalents at March 31 were as follows:

	2007	2006
Operating Fund:		
Repurchase agreements	\$ 23,026,564	26,852,198
Cash in State Comptroller's short-term investment pool	10,496,379	22,297,527
Petty cash and travel imprest accounts	31,000	31,000
Operating Fund cash and cash equivalents	\$ 33,553,943	49,180,725
Federal Fund:		
Repurchase agreements	\$ 65,989,275	32,054,044
Cash-net of outstanding bank checks	(10,639,314)	(61,315)
Federal Fund cash and cash equivalents	\$ 55,349,961	31,992,729

As of March 31, the cost and fair value of cash equivalents are as follows:

Operating Fund	2007		2006	
	Cost	Fair value	Cost	Fair value
Held by HESC's agent in HESC's name	\$ 23,026,564	23,026,564	26,852,198	26,852,198

Federal Fund	2007		2006	
	Cost	Fair value	Cost	Fair value
Held by HESC's agent in HESC's name	\$ 65,989,275	65,989,275	32,054,044	32,054,044

(5) Administrative Fees

The 1998 Amendments established three fees recorded in the Operating Fund for administering the loan program on behalf of the Federal Government based on performance as a guarantee agency.

A Default Aversion Fee is recognized for default aversion activities on delinquent loans at the time the lenders request aversion assistance between the 60th and 120th days of a borrower's delinquency. A fee of 1% of principal and interest on the loan may be charged to the Federal Fund at the time the guarantee agency receives a request from a lender for preclaim assistance. However, the fee must be refunded by the Operating Fund to the Federal Fund in the event the loan is later paid as a default claim. Accordingly, an estimate of default aversion fee refunds has been calculated and is presented as an Operating Fund liability and a receivable in the Federal Fund. The net default aversion fee is transferred from the Federal Fund to the Operating Fund on a monthly basis.

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A Loan Processing and Issuance Fee is paid based on the original principal amount of new loans guaranteed and disbursed during the period at a rate of 0.40%. This fee is paid to the Operating Fund on a quarterly basis.

An Account Maintenance Fee is calculated on the original principal amount of loans outstanding at a rate of 0.10%. This fee is paid directly by the U.S. Department of Education or as an authorized transfer from the Federal Fund on a quarterly basis.

For the years ended March 31, 2007 and 2006, the administrative fees receivable from U.S. Department of Education consisted of the following:

	2007	2006
Operating Fund:		
Loan processing and issuance fee receivable	\$ 4,547,153	4,115,374
Account maintenance fee receivable	6,173,029	—
	\$ 10,720,182	4,115,374

For years ended March 31, 2007 and 2006, administrative fee income is as follows:

	2007	2006
Operating Fund:		
Default aversion fee, net of estimated refunds	\$ 9,967,752	11,207,768
Loan processing and issuance fee	10,156,160	9,495,437
Account maintenance fee	23,428,532	25,924,481
	\$ 43,552,444	46,627,686

Gross default aversion fee income for the years ended March 31, 2007 and 2006 was \$12,972,163 and \$14,377,896, respectively. The estimated reserve for default aversion fee refunds is netted against default aversion fee income. In 2007 and 2006, the default aversion fee allowance estimate was 23.16% and 22.05% of default aversion fee income, respectively. The estimate of the amount to be refunded is based on current and historical data, which reflects actual experience over the past four years.

(6) Collections on Defaulted Loans

HESC management is required by Federal statutes to pursue collections on loans upon default claim payment. Collections on defaulted loans and related complements are recorded at the time such collections are received. All collection receipts are initially deposited in the Operating Fund and daily estimated collection transfers are made to the Federal Fund. The Operating Fund retains 23% of borrower payments, and retains 37% of rehabilitation collection payments. As a result of the Higher Education Reconciliation

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Act (HERA), the Operating Fund's retention on consolidated loans was reduced from 18.5% to 10% effective October 1, 2006.

(7) Interfund Balances

Interfund balances are monies due to and/or due from the Federal Fund to the Operating Fund and includes collection transfer balances, default aversion fees and federal default fees pending transfer. A daily transfer between funds is made based on an estimate of ED's equitable share of daily collections. A final settlement for the actual amount of collections due to the Federal Fund is made at month end.

In fiscal year 2007, the Operating Fund had a net interfund payable balance of \$4,255,392 which included a receivable from the Federal Fund for overpayment on collections activity of \$2,010,697. In fiscal year 2006, the Operating Fund had a net interfund receivable balance of \$13,877,162, which included a payable to the Federal Fund of substantially all unsettled collections activity. This is a result of a Federal Reinsurance payment received by the Operating Fund on March 31, 2006, which was subsequently transferred to the Federal Fund on April 1, 2006. In both years, the appropriate interest earnings were transferred with the funds' settlement at the end of the month. In addition, interfund Default Aversion Fee balances in the Operating Fund at March 31, 2007 and 2006 were \$717,765 payable to the Federal Fund and \$1,245,829 receivable from the Federal Fund, respectively. The default prevention fee payable from the Operating Fund to the Federal Fund totaled \$5,548,325, at March 31, 2007. In addition, the March 2006 balance included a \$9,979,190 account maintenance fee payable from the Federal Fund to the Operating Fund.

(8) Due from/to Other Sources

In 2006, Operating Fund revenue in the amount of \$229,930, was used to fund part of the Federal Gear Up program expenses, which was subsequently reimbursed to the Operating Fund after year end. In addition, at March 31, 2006 the Operating Fund owed the State Grants and Scholarship programs \$48,601. This is the remaining balance of a liability for FFELP expenses paid with grants and scholarship funds from April to June 2002, which have been offset with expenses of other State related programs which were paid from FFELP monies. During the 2007, fiscal year the liability balance was relieved and overpaid in the amount of \$63,398 which is a receivable from NYS at year end.

(9) New York State Initiatives

The 2006-2007 New York State budget appropriated \$11.7 million of Operating Funds to subsidize the Tuition Assistance Plan (TAP) and the Aid for Part Time Study Program (APTS). The TAP funding totaled \$5.4 million transferred in March 2007, the APTS payments totaled \$6.3 million made during the first two quarters of the state fiscal year.

The 2005-2006 New York State budget appropriated approximately \$56.9 million of the Operating Fund to subsidize TAP funding and APTS for the fiscal year. A transfer of \$46.6 million for TAP payments was completed in March 2006. The remaining \$4.7 million has been recorded as a payable at March 31, 2006 and was transferred in May 2006. The APTS payments totaled \$5.6 million.

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In addition, the Operating Fund was required to pay the operational expenses related to the administration of the State's grants and scholarship programs, which amounted to approximately \$14.4 million and \$13.3 million in 2006-2007 and 2005-2006, respectively.

(10) Training Grant for Financial Aid Professionals

In fiscal year 2006, HESC provided grants of up to \$10,000 to schools for financial aid professional staff training. Schools were able to use these funds to pay for financial aid and bursar office staff attendance at student financial aid training provided by HESC, the U.S. Department of Education, and national, statewide and regional professional financial aid member associations. All grant funds were disbursed by March 31, 2006.

(11) Transfer to Federal Fund

Section 422A of the Higher Education Act states, "each agency shall maintain in the Federal Student Loan Reserve Fund a current minimum reserve level of 0.25% of the total attributable amount of all outstanding loans guaranteed by the agency" calculated at September 30 of each year. As of September 30, 2006, HESC's Federal Student Loan Reserve Fund balance fell below this required minimum reserve level to 0.1269%. To remain in compliance with regulations, HESC transferred \$32.2 million from the Operating Fund to the Federal Fund, bringing the reserve level to .2500%. As of September 30, 2005, HESC's Federal Student Loan Reserve Fund balance fell to 0.2384% requiring a, HESC transfer of \$3.5 million from the Operating Fund to the Federal Fund, bringing the reserve level to 0.2521%.

(12) Capital Assets

Capital assets are recorded at cost. Capital assets are defined as assets with initial, individual costs exceeding a capitalization threshold of \$25,000. Depreciation for Operating Fund assets is based on an estimated five year useful life, using an accelerated depreciation method. The majority of the Federal and Operating Funds' capital assets consists of computer equipment, while a small part of these assets are office equipment.

Capital asset activity in the Operating Fund for the year ended March 31, 2007 is as follows:

	Balance April 1, 2006	Additions	Reductions	Balance March 31, 2007
Office and computer equipment	\$ 1,318,852	—	—	1,318,852
Less accumulated depreciation	(1,090,681)	(100,529)	—	(1,191,210)
Net capital assets	<u>\$ 228,171</u>	<u>(100,529)</u>	<u>—</u>	<u>127,642</u>

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Capital asset activity in the Operating Fund for the year ended March 31, 2006 is as follows:

	Balance April 1, 2005	Additions	Reductions	Balance March 31, 2006
Office and computer equipment	\$ 1,229,236	89,616	—	1,318,852
Less accumulated depreciation	(938,454)	(152,227)	—	(1,090,681)
Net capital assets	<u>\$ 290,782</u>	<u>(62,611)</u>	<u>—</u>	<u>228,171</u>

At March 31, 2007 and 2006, the Federal Fund had capitalized equipment with a book value of \$294,255, which was fully depreciated.

(13) Federal Reserve Recall and Federal Advances

The 1998 Amendments to the Higher Education Act contain a provision for a recall of federal reserve funds held by guarantee agencies totaling \$250 million nationwide. HESC's share of this recall is \$18,222,100. HESC transferred \$6,195,514 to the U.S. Treasury on September 3, 2002. The second payment of \$6,013,293 was paid to U.S. Treasury on September 6, 2006. The remaining payment of \$6,013,293 will be paid in September 2007.

HESC has received, in prior years, non-interest bearing advances from the U.S. Department of Education totaling \$10,300,348, for the purpose of helping to strengthen FFELP through the infusion of additional working capital. Under the terms of the agreement, HESC will be required to repay these advances at such time as the amount of federally guaranteed loans outstanding (note 3) is reduced to less than \$54,950,000.

Long-term obligation activity for the year ended March 31, 2007, is as follows:

Federal Fund	Beginning balance	Additions	Reductions	Ending balance	Due within one year
Federal Reserve recall	\$ 12,026,586	—	(6,013,293)	6,013,293	6,013,293
Federal advances	10,300,348	—	—	10,300,348	—
Total Federal Fund	<u>\$ 22,326,934</u>	<u>—</u>	<u>(6,013,293)</u>	<u>16,313,641</u>	<u>6,013,293</u>

Long-term obligation activity for the year ended March 31, 2006, is as follows:

Federal Fund	Beginning balance	Additions	Reductions	Ending balance	Due within one year
Federal Reserve recall	\$ 12,026,586	—	—	12,026,586	6,013,293
Federal advances	10,300,348	—	—	10,300,348	—
Total Federal Fund	<u>\$ 22,326,934</u>	<u>—</u>	<u>—</u>	<u>22,326,934</u>	<u>6,013,293</u>

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(14) Purchase of Defaulted Federal Loans

Purchases of defaulted loans and amounts repurchased by lenders are recorded as Federal Fund activity. The reinsurance reimbursement results in a net reduction to the Federal Fund, due to reduced reinsurance rates of 98% and 95% as a result of various amendments to the Higher Education Act.

The Higher Education Act, as amended, also authorizes the Secretary to recognize qualified lenders, guaranty agencies and servicers for an exceptional level of performance in servicing FFEL program loans, making designated lenders and servicers eligible for 100% reimbursement on all claims submitted for insurance during the 12 month effective period. As of March 31, 2007, HESC was processing claims for 14 servicers, with multiple lenders under the exceptional performer designation.

(15) Federal Default Fee

As a result of the Deficit Reduction Act of 2005, signed into law by the President in February 2006, a 1% default fee must be deposited into the Federal fund on all Stafford and PLUS loans guaranteed after July 1, 2006. The fees are Federal Fund revenue subject to the Federal Fund's restricted use. This fee replaces the guarantee fee (insurance premium) which was not a mandatory fee. HESC has elected to pay the 1% default fee from the Operating Fund instead of charging borrowers the fee on their Stafford or PLUS loans.

HESC's Agency Operating Fund transferred to the Federal Fund approximately \$20.0 million in Federal default fees on behalf of the borrowers during the state fiscal year ended March 31, 2007.

(16) Pension Benefits

Substantially all employees working for the Guaranteed Student Loan Programs are members of the New York State and Local Employees' Retirement System (System), a cost-sharing, multiple employer public employee retirement system. The State Comptroller is sole trustee and administrative head of the System. The System issues a publicly available financial report that includes financial statements and required supplementary information which may be obtained by writing to the New York State and Local Employees' Retirement System, 110 State Street, Albany, New York 12236.

The System provides retirement benefits as well as death and disability benefits. All benefits vest after five years of accredited service. Retirement benefits are established by the New York State Retirement and Social Security Law. Retirement benefits and contributory requirements depend upon the point in time at which an employee last joined the system. Most members of the System who joined before July 27, 1976 are enrolled in a noncontributory plan. The Operating Fund contributes the entire amount determined to be payable to the system for these employees. Personnel who joined the System after July 27, 1976 are required by law to contribute 3% of their gross salary. The Operating Fund contributes the balance payable to the System for these employees.

The Operating Fund paid to the System \$3,392,998 for 2007, \$3,855,715 for 2006, and \$2,608,761 for 2005 to cover 100% of the required employer contributions for retirement benefits. These payments, made through application of the New York State Fringe Benefit rate calculated by the State's Division of the Budget, represent 9.81%, 12.12%, and 8%, of covered payroll for each of the years, respectively.

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(17) Postretirement Benefits

In addition to the pension benefits described in note 16, health insurance coverage and survivor benefits for retired employees and their survivors are provided. Substantially all of the employees of the Guaranteed Student Loan Programs may become eligible for these benefits if they reach normal retirement age while working for the State. Health care benefits are provided through an insurance company whose premiums are based on the benefits paid during the year. The Operating Fund recognizes the cost of providing health insurance by recording its share of health insurance premiums as an expense, as determined through the New York State fringe benefit rate, based upon fringe benefit costs incurred by all State agencies. Additionally, the survivors' benefit program provides for a death benefit to be paid partially by the Operating Fund, through the fringe benefit payment, to a retiree's designated beneficiary.

(18) Employees' Vacation Pay Benefits

Under the terms of HESC management's personnel policies and its union agreements, vacation pay benefits may be paid upon termination up to a combined maximum of 30 days. The Operating Fund recognizes employees' vacation pay benefits when earned. The liability for employees' vacation pay benefits is \$2,646,298 and \$2,525,286 as of March 31, 2007 and 2006, respectively, and is recorded in accounts payable and accrued expenses in the Operating Fund.

(19) Deferred Compensation

New York State offers its employees, including HESC employees, a deferred compensation plan created in accordance with Internal Revenue Code Section 457. The plan, available to all employees, permits them to defer a portion of their salary until future years. The deferred compensation is not available to employees until termination, retirement, death, or unforeseeable emergency. All amounts of compensation deferred under the plan are placed in trust for participants and their beneficiaries.

(20) Leases

HESC leases office space and storage space under noncancelable operating leases and month to month agreements. Total rental expense recorded in the Operating Fund, which includes utilities for one of two major leases, for the years ended March 31, 2007 and 2006, were \$1,340,855 and \$1,498,154, respectively. The major lease for office space expired on March 31, 2007, and a new lease at the same location has been executed that will be effective through 2017.

(21) Contingencies

The Operating Fund and the Federal Fund are subject to U.S. Department of Education (ED) oversight and audit that at times may result in program issues and potential liabilities payable to ED. The issues relate to possible violations of rules and regulations established by ED to administer the federal loan program. Management diligently attempts to interpret ED's rules and regulations, and believes that its implementation of policies and procedures properly adheres to those rules and regulations, and that any resulting liabilities would not be material.

**THE GUARANTEED STUDENT LOAN PROGRAMS'
OPERATING FUND AND FEDERAL FUND OF
THE NEW YORK STATE HIGHER EDUCATION
SERVICES CORPORATION**

Notes to Financial Statements

March 31, 2007 and 2006

During the normal course of business the Guaranteed Student Loan Programs are involved in various legal proceedings and investigations, pertaining to matters relating to the Programs' operations and activities. While these proceedings and investigations may lead to a possible liability, in the opinion of HESC management, after considering all relevant facts, these possible liabilities will not in the aggregate have a material adverse effect on the financial position of the Operating Fund or Federal Fund.

HESC is exposed to various risks of loss related to damage and destruction of assets, injuries to employees, or noncompliance with Federal requirements and other natural and other unforeseen disasters. HESC in general does not insure its buildings, contents or related risks and does not insure its assets for claims and assessments arising from bodily injury, property damages, and other perils. Unfavorable judgments, claims, or losses incurred by HESC are covered by the State on a self-insured basis. The State does have fidelity insurance on State employees.

(22) Subsequent Events

On October 7, 2005, HESC submitted a letter for approximately \$16.9 million to the U.S. Department of Education (ED) seeking reimbursement for additional rehabilitated loan retention not previously requested, for the periods April 1996 through September 2004. The amount of reimbursement requested represents agency retention on rehabilitated loans. From April 1996 through September 2004, HESC retained only the collection costs charged borrowers on rehabilitated loans. The remaining funds, including agency retention, were transferred to ED. Subsequent to clarification by ED, HESC changed its procedures prospectively to report rehabilitated loans and calculate agency retention as instructed.

On April 19, 2007, HESC received a letter from the Chief Business Operations Officer, Financial Student Aid at ED resolving the outstanding rehabilitation issue. ED authorized HESC to transfer amounts in the Federal Fund which exceed the minimum required reserve level until the full \$16.9 million is recuperated in the Operating Fund. This agreement is valid from September 30, 2007 to September 30, 2010. As the Federal Fund has had subsidies from the Operating Fund in the past two years in order to meet the required minimum reserve levels, the \$16.9 million is contingent upon the Federal Fund having sufficient excess funds above the minimum reserve level. As such no amounts have been recorded as revenue or due to the Operating Fund.